IT 00-26
Tax Type: Income Tax
Issue: Section 78' Gross-Up Amount Should Be Included in the Sales Factor Subpart F

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 98-IT-0000**
	FEIN 00-0000000
v.	**Tax yrs. 1988-1990**
ABC & Co., Taxpayer	**Charles E. McClellan Administrative Law Judge**

ORDER ON CROSS-MOTIONS FOR SUMMARY JUDGMENT

Synopsis

This matter comes on for cross motions for summary judgment filed by ABC & Company, Inc. ("taxpayer") and the Department of Revenue ("Department") in a case initiated by amended income and replacement tax returns which the taxpayer filed for the years 1988, 1989 and 1990. On October 16, 1998, the Department issued a letter to taxpayer denying its claims. The sole legal issue presented by the amended returns and by the taxpayer's motion and the Department's cross-motion concerns dividends received from foreign affiliates ("foreign dividends"), "Subpart F income"[1] and the "Section 78

[1] Subpart F of the Internal Revenue Code ("IRC"), Sections 951-964, 26 U.S.C. § 951-964, requires U.S. parent corporations to report as income a calculated portion of the earnings and profits of their foreign affiliates even though those earnings and profits have not been distributed as dividends. As discussed infra,

gross-up"[2] which are included in taxpayer's gross income on its federal income tax returns, but which are excluded from base income under Section 203(b)(2) of the Illinois Income Tax Act[3]. The issue is whether, as a matter of law, these items should be included in the sales factor of the apportionment formula as asserted by the taxpayer or omitted as argued by the Department.[4]

As explained below, I am granting the Department's motion and denying the taxpayer's motion. If adopted, my recommendation will dispose of this case.

Undisputed Facts

The undisputed facts are as follows:

1. The years at issue in this matter are the tax years ending December 31, 1988, December 31, 1989, and December 31, 1990.
2. Taxpayer is a New Jersey corporation headquartered in Anywhere, New Jersey.
3. Taxpayer is a global, research-driven pharmaceutical company that develops, manufactures, markets, and delivers a wide variety of human and animal health products.
4. In February 1995, taxpayer filed amended income and replacement tax returns for each of the years at issue, adjusting its sales factor to include the foreign dividends, the Subpart F income and the Section 78 gross-up

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the definition of Subpart F income encompasses a number of items in addition to foreign subsidiary earnings.

[2] The "Section 78 gross-up" is an adjustment to a parent company's income required under § 78 of the Internal Revenue Code that represents a portion of the income tax paid by the foreign affiliate to its parent country from its pre-tax earnings and profits.

[3] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq*., the Illinois Income Tax Act (the "Act").

reported on its federal income tax returns.

5. Taxpayer did not include any of the foregoing amounts in its base income subject to apportionment for the years at issue.

6. On October 16, 1998, the Illinois Department of Revenue ("Department") issued taxpayer a Notice of Denial, disallowing in their entirety taxpayer's refund claims for the years at issue.

Conclusions of Law

A motion for summary judgment is appropriate where the pleadings, affidavits, and other documents on file show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. 735 ILCS 5/2-1005, Purtill v. Hess, 111 Ill.2d 229, 489 N.E.2d 867 (1986). In this case, the parties agree that there is no genuine issue of material fact in this cause, so summary judgment is appropriate.

This case involves an issue of statutory construction. Long-standing rules of statutory construction that apply to this case are that taxing statutes are to be strictly construed, that the language of the statute may not be extended or enlarged by implication and that, in cases of doubt, the language is construed in favor of the taxpayer and against the Department. Van's Material Co. v. Department of Revenue, 131 Ill.2d 196 (1989). Since the motions now being considered involve the application of a taxing statute, these rules of construction must be applied.

[4] The apportionment formula is applied to the business income included in the taxpayer's base income to determine the portion of business income apportionable to Illinois.

The issue presented in both motions involves the apportionment formula set forth in Section 304. If a corporation does business in Illinois and one or more other states, the Illinois statute requires the application of a three-factor formula to apportion the corporation's business income to Illinois. General Telephone co. v. Johnson, 103 Ill.2d 363, 83 Ill.Dec. 133, 469 N.E.2d 1067, (1984). The apportionment formula is set forth in Section 304(a). In General Telephone, the Illinois Supreme Court described the operation of Section 304(a)'s three-factor formula in the following terms:

> The formula-apportionment method prescribed by section 304(a) first requires that the taxpayer compute three factors, which are based on his property, payroll, and sales. The property factor is a fraction whose numerator is the taxpayer's Illinois property, and whose denominator is all of the taxpayer's property. The payroll and sales factors are computed similarly (i.e., Illinois payroll/all payroll; Illinois sales/all sales).[5] Section 304(a) then requires the taxpayer to average the three factors, with the resulting fraction being the taxpayer's 'apportionment factor.' The section 304(a) apportionment factor is the percentage of the taxpayer's business income that will be taxed in Illinois. 103 Ill.2d at 370, 83 Ill.Dec. at 136, 469 N.E.2d at 1070.

The apportionment factor at issue in the motions for summary judgment filed in this case is the sales factor. The taxpayer argues in its motion that the foreign dividends, the Subpart F income and the Section 78 gross-up are "sales" as defined in the statute and should be included in the sales factor of taxpayer's apportionment formula for each year. The Department argues that the foreign dividends, the Subpart F income and the Section 78 gross-up are not included in base income against which the apportionment formula is applied to apportion income to Illinois so these amounts should not be included in the

[5] Section 304(a) was amended by P.A. 84-1382, approved September 14, 1986, to double weight the sales factor effective for taxable years ending on or after January 1, 1987.

sales factor. The Department also argues that to include them in the sales factor would be contrary to the "water's edge" unitary concept adopted in 1982 for American corporations with foreign subsidiaries.

The term "sales" is defined in Section 1501(a)(21) to mean "all gross receipts of the taxpayer not allocated under Sections 301, 302 and 303." Sections 302, dealing with compensation paid to nonresidents, and 303, dealing with nonbusiness income of persons other than residents, are not relevant to the facts of this case.

Section 301(c), in relevant part, reads as follows:

> (c). Other persons. (1). In general. Any item of income or deduction which was taken into account in the computation of base income for the taxable year by any person other than a resident and which is referred to in Section 302, 303, or 304 (relating to compensation, nonbusiness income and business income, respectively) shall be allocated to this State only to the extent provided by such section.
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> (2) Unspecified items. Any item of income or deduction which was taken into account in the computation of base income for the taxable year by any person other than a resident and which is not otherwise specifically allocated or apportioned pursuant to Section 302, 303, or 304 (including, without limitation, interest, dividends, items of income taken into account under the provisions of Sections 401 through 425 of the Internal Revenue Code, and benefit payments received by a beneficiary of a supplemental unemployment benefit trust which is referred to in Section 501(c)(17) of the Internal Revenue Code):
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> (B) In the case of a corporation or a partnership, shall be allocated to this State if the taxpayer had its commercial domicile in this State at the time such item was paid, incurred or accrued.

Taxpayer argues that the foreign dividends, the Subpart F income and the Section 78 gross-up are gross receipts within the statutory definition of the term "sales" in Section 1501(a)(21), and in the Department's regulation, 86 Ill. Admin. Code § 100.3370(a)(1).

Taxpayer's assertion is incorrect because it conflicts with the statutory language that defines the term "sales" as used in the statute. Section 1501(a)(21) provides that "the term 'sales' means all gross receipts of the taxpayer not allocated under Section 301, 302, and 303." As noted above, Sections 302 and 303 are not relevant to this matter. Sections 301(c)(1) and (2) refer to items of income "taken into account in the computation of base income." To be taken into account in the computation of base income, the foreign dividends, Section 78 gross-up and the Subpart F income would have to be items of income "taken into account in the computation of base income." However, they are not taken into account in the computation of base income because they are eliminated from the base income computation by the subtraction modifications provided by Sections 203(b)(2) subparagraphs (G) and (O). Section 203(b)(2)(G) provides for a subtraction modification for the Section 78 gross-up. Section 203(b)(2)(O) provides for a subtraction modification for foreign dividends and Subpart F income.

The phrase "taken into account" is not defined in the statute. It was, however, addressed by the U.S. Supreme Court in American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983), wherein the court interpreted the federal statute that prohibits state or local taxation of federal obligations or interest paid thereon. The statute provided that the prohibition "extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax." *Id.* at 862. The court stated that "In context, the word 'considered' means taken into account, or included in the accounting." (*Id.*) Having been eliminated by the subtraction modifications, the foreign dividends, the Subpart F income and the Section 78 gross-up amount at issue in this case are not "taken into account" in

computing base income as required by Sections 301(c)(1) and (2). Therefore, they do not come within the statutory definition of "sales", and for that reason they cannot be included in the sales factor.

Although there are no precedents in Illinois case law dealing with the issue of whether subtraction modification items described in Section 203(b)(2) subparagraphs (G) and (O) are includible in the sales factor, the Illinois Supreme Court dealt with the issue of whether the subtraction modification described in Section 203(b)(2)(J) is includible in the sales factor in Continental Illinois National Bank v. Lenckos, 102 Ill.2d 210, 464 N.E.2d 1064 (1984). The principle enunciated in that case is controlling on the issue at hand. In considering the application of the principle set forth in Continental Illinois National Bank v. Lenckos to the issue in this case, it is important to keep in mind the purpose of the apportionment formula which the court described as follows: "[T]he purpose of the apportionment formula is to confine the taxation of business income to that portion which is attributable to activities in Illinois." Continental Illinois National Bank, 102 Ill.2d at 224, (quoting Caterpillar Tractor Co. v. Lenckos, 84 Ill.2d 102. 125, 417 N.E.2d 1343 (1981)).

In Continental Illinois National Bank, the taxpayer deducted from base income pursuant to Section 203(b)(2)(J) interest it had received on obligations of the U.S. Government. The Department included this interest in the sales factor even though it was not included in base income. The court found that by including the interest received on the U.S. obligations in the apportionment formula, the Department was doing indirectly what it could not do directly, *i.e.*, taxing income that was exempt by statute. The court stated, “It is illogical to assume that the legislature would design an apportionment

formula to apportion income to be taxed by the Department which includes income that is exempt from tax." 102 Ill.2d at 224. Relying on American Bank & Trust Co. v. Dallas County, *supra*, the court held that "tax exempt interest on obligations of the United States may not be taken into consideration in apportioning taxable income." 102 Ill.2d at 225.

Taxpayer's argument is illogical in the same way as the Department's was in Continental Bank v. Lenckos, s*upra*. The corollary to this principle is that it is illogical to assume that the General Assembly would devise a formula to measure taxable income which excludes income that is clearly taxable in Illinois. The fallacy of taxpayer's argument is apparent from looking at the consequences and the distortion in apportionment that would result from including items in the apportionment formula that are not included in the business income being apportioned.

Taxpayer's headquarters are located in New Jersey. Section 304(a)(3)(C) provides that sales other than sales of tangible personal property are in Illinois if the income-producing activity is in Illinois. Relying on this provision, taxpayer takes the position that all of the business activity that produced this income was in New Jersey and none of it in Illinois. Accordingly, taxpayer includes 100% of these items in the denominator of the sales factor but none of it is included in the numerator. This distorts the apportionment of business income by decreasing the amount apportioned to Illinois. Consequently, business income derived from business activities conducted in Illinois would not be apportioned to Illinois.

If, on the other hand, the taxpayer's commercial domicile were located in Illinois, taxpayer's theory would require that 100% of the foreign dividends, the Subpart F income and the Section 78 gross-up amount be included in both the numerator and in the

denominator of the sales factor. This would disproportionately increase the amount of business income apportioned to Illinois and result in business income being apportioned to Illinois that was derived from business activities outside of Illinois.

In both cases, the apportionment of business income is distorted because the sales factor of the apportionment formula, which is intended to measure business activity by apportioning business income, is being distorted by introducing into the apportionment formula items that are not included in business income or related to the business income being apportioned. Under taxpayer's theory, two taxpayers with exactly the same domestic and foreign source income would have different apportionment results resulting in different income tax liabilities. All other factors being the same, the corporation with a domicile in Illinois pays more income tax to Illinois than a corporation with its commercial domicile outside of Illinois. It is inconceivable that in formulating the rules on apportionment, the General Assembly would have intended that business income apportioned to Illinois depend on whether a corporation has its commercial domicile in Illinois or in some other state. Such apportionment distortion is contrary to the purpose of the apportionment formula which is "to confine the taxation of business income to that portion which is attributable to activities in Illinois." Continental Illinois Bank v. Lenckos, *supra*.

The taxpayer argues further that the court's statement in Continental Illinois Bank v. Lenckos quoted above is at odds with its own description of the purpose of the apportionment formula itself as set forth in GTE Automatic Electric, Inc. v. Allphin, 68,

Ill.2d 326 (1977). Taxpayer memo pp. 2-3.[6] Taxpayer states that the court in GTE Automatic Electric, Inc. v. Allphin, at 68 Ill.2d at 339-340, "described the apportionment formula as a method of measuring not *taxable income*, but rather as a method of measuring *business activity*." (emphasis in original) Taxpayer memo p. 3.

Taxpayer's assertion is incorrect. The court's statement in Continental Bank v. Lenckos is not at odds with what it said in GTE Automatic Electric, Inc. v. Allphin. Taxpayer correctly asserts that these cases make it clear that the apportionment provisions in Section 304 are intended to apportion the business activity of a corporation's multi-state operations between the taxing state and other states. If the sales factor in the apportionment formula is determined without including items that are not included in the business income being apportioned, the apportionment provisions in Section 304 do accurately measure business activity between Illinois and the other states in which a taxpayer does business.

Taxpayer argument also ignores the statutory structure that prescribes how that measurement of business activity is made. Under the Act, Section 201(a) is the starting point for calculating the income subject to tax for a corporation with operations in multiple jurisdictions, including foreign countries. Section 201(a) imposes a tax on net income. The term net income is defined in Section 202. That section provides that "a taxpayer's net income for a taxable year shall be that portion of his base income for such year . . . which is allocable to this State under the provisions of Article 3 . . .." (Article 3 contains Sections 301 through 308.)

[6] Taxpayer's memorandum filed in support of its motion is referred to by page number as "Taxpayer memo p". The Department's memorandum filed in support of its cross-motion is referred to by page number as "Dept. memo p."

Section 203(b) provides that a corporation's base income is its taxable income for the taxable year as adjusted for specified addition and subtraction modifications. The term taxable income is not defined in the Act. However, where a term is not defined in the Act, but is a term that is used in the Internal Revenue Code (26 U.S.C. § 1 *et seq*.) for purposes of the Act it has the same meaning as it does in the Internal Revenue Code. 35 ILCS 5/102. Thus, in the case of a corporation, taxable income means federal taxable income as determined under the Internal Revenue Code.

With this statutory pattern in mind, the starting point of the Illinois tax calculation is taxable income which means federal taxable income. The next step in arriving at base income is to add and subtract from taxable income the statutory modifications set forth in Section 203(b)(2). Insofar as they are relevant to this case, there are three subtraction modifications set forth in Section 203(b)(G) and (O). These subtraction modifications are for foreign dividends, the Section 78 gross-up and Subpart F income derived from foreign affiliates not treated as being members of the parent's affiliated group for inclusion in the parent's consolidated federal return under Internal Revenue Code § 1504(b)(3).

The amount left after making the addition and subtraction modifications to taxable income is base income. Base income can include both business income as defined in Section 1501(a)(1) and non-business income as defined in Section 1501(a)(13). Because only the business income resulting from taxpayer's business activities in Illinois is subject to tax, Section 304 (a) requires corporations operating in Illinois and other states to apportion the business income portion of their base income using the three-factor

formula described above. Accordingly, since the base income amount calculated up to this point may include both business income and non-business income, the next step is to subtract non-business income from the base income amount determined up to this point. The remaining amount after that subtraction is business income subject to apportionment. This amount is then multiplied by the apportionment formula to measure the income derived from the taxpayer's business activities in Illinois, and the result of that calculation is added to non-business income to arrive at the base income allocable to Illinois as directed by Section 202. Certain other adjustments, not relevant to the issues in this case, are made and the result is the statutorily prescribed net income on which the tax is imposed by Section 201. This analysis shows that the statutory formula is designed to and does apportion only business income.

As is obvious from the statutory tax structure, because of the subtraction modification in Sections 203(b) (G) and (O), foreign dividends, Section 78 gross-up and Subpart F income have been eliminated from the base income leaving only business income subject to apportionment. Therefore, it would not be reasonable or logical to include these items in the sales factor of the apportionment formula which is used to apportion taxable business income. If they are included, as illustrated above, distortion will result.

Taxpayer's interpretation of the statute also ignores the fact that Subpart F income and the Section 78 gross-up are not gross receipts of any kind. They are adjustments prescribed by the IRC to the income of a United States corporation that has foreign affiliates.

The Subpart F provisions generally treat all or part of the undistributed earnings of a foreign subsidiary as if they had been distributed to the United States parent corporation in the years in which they are earned. Kraft, Inc. v. Sweet, 213 Ill.App.3d 889, 572 N.E.2d 389 (4th Dist. 1991). In addition to undistributed foreign subsidiary earnings, there are other items included in the definition of Subpart F income that are not "income" in any ordinary sense of the word and will never be distributed as a dividend to the parent. These include long term loans made to a United States parent by a foreign subsidiary and amounts spent by a foreign subsidiary to purchase United States property to lease to its parent. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 15.62 (6th ed. 1998). Illegal bribes and kickbacks are also included in the statutory definition of Subpart F income. *Id*., IRC § 952.

The "Section 78 gross-up" amount is an adjustment to a parent company's income required under § 78 of the Internal Revenue Code which was designed to eliminate a perceived loophole in the foreign tax credit provisions of the IRC. It increases the income of the parent by a percentage of the taxes paid by the foreign corporation on its pre-tax earnings from which it paid its post-tax dividends. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 15.21[2], at 15-69 (6th ed. 1998); Dow Chemical Company v. Comm., 378 Mass. 254, 391 N.E.2d 253 (1979). It has been described as a fictional increase in the gross income of a United States parent. 378 Mass. at 264. Subpart F income and the Section 78 gross-up are not receipts of any kind.

Taxpayer's theory of the apportionment formula also runs contrary to the unitary combination method of taxing multinational corporations adopted in Illinois in 1982. The Department correctly maintains in its memorandum that the taxpayer's argument is

inconsistent with this method, the so-called "water's edge" unitary combination method of taxing multinational corporations. The legislature adopted the water's edge method in 1982 with the enactment of P.A. 82-1029. With the enactment of that act, Illinois went from an income tax system that allowed world wide unitary combination to a scheme that excludes from the unitary business group member corporations which have 80% or more of their business activities outside of the United States. 35 ILCS 5/1501(a)(27). P.A. 82-1029 also amended the Act by adding Sections 203(b)(2)(G) and (O) to provide for the subtraction modification for Section 78 gross-up, Subpart F income and dividends paid by foreign subsidiaries that would be unitary group members if their business activities were conducted in the United States. 35 ILCS 5/203(b)(2)(G) and (O). Finally, P.A. 82-1029 amended the Act to eliminate from the sales factor sales by U.S. parent corporations to foreign subsidiaries that would be members of the unitary group except for the fact that their business activities are conducted outside the United States. 35 ILCS 5/304(a)(3)(B)(ii) [7]

The effect of these amendments and the obvious intent was to exclude income from foreign subsidiaries from the Illinois income tax base.

In General Telephone Co. v. Johnson, 103 Ill.2d 363, 373 (1984) the court commented on the effect of these amendments as follows:

> The legislature rejected worldwide combined apportionment, however, and instead adopted a domestic version which excludes from the unitary business group any member whose activities are carried on primarily outside of the United States. This domestic combined apportionment also strictly limits formulary consideration

[7] See Internal Revenue Code § 1504(b)(3)

> of foreign dividend income as well as sales between United States and foreign members of the same unitary group.

This language means that foreign source dividends, Section 78 gross-up and Subpart F Income from subsidiaries of U.S. companies cannot be included in the sales factor to distort the apportionment of business income, whether the parent corporation is domiciled in Illinois or in any other state.

Taxpayer's final argument is that excluding the foreign dividends and Section 78 gross-up violates the holding in Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 169 (1983), that under "the Due Process Clause of the Fourteenth Amendment to the United States Constitution, the factors used in an apportionment formula "must actually reflect a reasonable sense of how income is generated." Along the same line, taxpayer argues that if the apportionment formula excludes the Section 78 gross-up, the Subpart F Income and foreign dividends, then the income apportioned to Illinois will be out of all proportion to the business taxpayer conducted in the state, citing Hans Rees' Sons v. North Carolina, 283 U.S. 123 (1931).

Although taxpayer alleges that "excluding the amounts at issue here from the sales factor, . . . fails to reflect how taxpayer generates its income, and leads to a grossly distorted representation of taxpayer's business in [Illinois]," taxpayer fails to present any constitutional analysis demonstrating any distortion. As demonstrated above, quite the opposite is true because by excluding these amounts from the sales factor, taxpayer's income generated in Illinois is fairly measured. The analysis above also shows that it is the taxpayer's assertion of the determination of the sales factor in the apportionment

formula that would distort the apportionment out of all proportion to the business conducted in Illinois.

WHEREFORE, taxpayer's Motion for Summary Judgment is denied and the Department's Motion for Summary Judgment is granted.

Because there are no other issues in this matter, I recommend that this order be considered the final recommendation in this case and that the denial of taxpayer's claims for refund filed on its amended returns be made final.

ENTER: November 3, 2000

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Administrative Law Judge